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PG&E Energy Services

AZ CORP COMMISSION

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January 21, 1998

Arizona Corporation Commission
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Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. U-0000-94-165

Dear Sir or Madam:

Pursuant to Arizona Corporation Commission's Amended Procedural Order, enclosed are: (1) testimony of Douglas A. Oglesby on behalf of PG&E Energy Services; and (2) testimony of Tom Broderick on behalf of the Arizona School Boards Association, Inc.

If you have any questions, please contact me at (602) 874-4066.

Sincerely,

Tom Broderick

Tom Broderick
Regulatory Consultant
PG&E Energy Services

Enclosure

For Parties of Record in Docket No. U-0000-94-165

Copies of the foregoing were mailed and/or delivered on this 21st day of January, 1998, to the following:

Greg Patterson
RUCO
2828 N. Central Ave., Suite 1200
Phoenix, AZ 85004

Michael A. Curtis
MARTINEZ & CURTIS, P.C.
2712 N. Seventh Street
Phoenix, AZ 85006

Walter W. Meek
President
ARIZONA UTILITY INVESTORS ASSOCIATION
2100 N. Central Ave., Suite 210
Phoenix, AZ 85004

Rick Gilliam
LAND & WATER FUND OF THE ROCKIES
2260 Baseline Road, Suite 200
Boulder, CO 80302

Charles R. Huggins
ARIZONA STATE AFL-CIO
110 N. Fifth Avenue
P.O. Box 13488
Phoenix, AZ 85002

Norman J. Furuta
DEPARTMENT OF THE NAVY
900 Commodore Dr., Bldg. 107
P.O. Box 272 (Attn. Code 90C)
San Bruno, CA 94066-7020

For Parties of Record in Docket No. U-0000-94-165

Sam DeFrawi
Rate Intervention Division
NAVAL FACILITIES ENGINEERING COMMAND
200 Stovall St., Rm. 10512
(Attn. Code 16R)
Alexandria, VA 22332-2300

AJO IMPROVEMENT COMPANY
P.O. Drawer 9
Ajo, AZ 84321

MOHAVE ELECTRIC COOPERATIVE, INC.
P.O. Box 1045
Bullhead City, AZ 86430

MORENCI WATER & ELECTRIC COMPANY
P.O. Box 68
Morenci, AZ 85540

Betty Pruitt
ARIZONA COMMUNITY ACTION ASSOCIATION
202 E. McDowell #255
Phoenix, AZ 85004

Choi Lee
PHELPS DODGE CORPORATION
2600 N. Central Avenue
Phoenix, AZ 85004-3014

Bradley Carroll
TUCSON ELECTRIC POWER COMPANY
P.O. Box 711
Tucson, AZ 85702

Creden Huber
SULPHUR SPRINGS VALLEY ELECTRIC COOPERATIVE
P.O. Box 820
Willcox, AZ 85644

For Parties of Record in Docket No. U-0000-94-165

Mick McElrath
CYPRUS CLIMAX METALS COMPANY
P.O. Box 22015
Tempe, AZ 85285-2015

Dan Neidlinger
23020 North 17th Drive
Phoenix, AZ 85015

Jessica Youle
SALT RIVER PROJECT
P.O. Box 52025
PAB 300
Phoenix, AZ 85072-2025

Patricia Cooper
AEPCO
P.O. Box 670
Benson, AZ 85602-0670

Clifford Cauthen
GRAHAM COUNTY ELECTRIC CO-OP
P.O. Drawer B
Pima, AZ 85543

Marv Athey
TRICO ELECTRIC COOPERATIVE
P.O. Box 35740
Tucson, AZ 85740

Wayne Retzlaff
NAVOPACHE ELECTRIC CO-OP, INC.
P.O. Box 308
Lakeside, AZ 85929

Craig Marks
CITIZENS UTILITIES COMPANY
2901 N. Central Ave.
Suite 1660
Phoenix, AZ 85012

For Parties of Record in Docket No. U-0000-94-165

Steve Kean
ENRON
P.O. Box 1188
Houston, TX 77251-1188

Jack Shilling
DUNCAN VALLEY ELECTRIC COOPERATIVE
P.O. Box 440
Duncan, AZ 85534

Ken Saline
K.R. SALINE & ASSOCIATES
P.O. Box 30279
Mesa, AZ 85275

Phyllis Rowe
ARIZONA CONSUMERS COUNCIL
6841 North 15th Place
Phoenix, AZ 85014

C. Webb Crockett
FENNEMORE CRAIG
Two North Central Ave., Suite 2200
Phoenix, AZ 85004-2390

Sam DeFrawi
Navy Rate Intervention
DEPARTMENT OF THE NAVY
901 "M" St., S.E.
Bldg. 212
Washington, DC 20374

Robert S. Lynch
340 E. Palm Lane, Suite 140
Phoenix, AZ 85064-4528

Michael Block
GOLDWATER INSTITUTE
201 N. Central
Bank One Center, Concourse Level
Phoenix, AZ 85004

For Parties of Record in Docket No. U-0000-94-165

John Branch
CITY OF MESA ELECTRIC UTILITY
P.O. Box 1466
Mesa, AZ 85211-1466

Douglas C. Nelson, P.C.
7000 North 16th Street
Suite 120-307
Phoenix, AZ 85020

Lawrence V. Robertson, Jr.
MUNGER CHADWICK, P.L.C.
333 North Wilmot, Suite 300
Tucson, AZ 85711-2634

Tom Broderick
6900 E. Camelback Rd., #800
Scottsdale, AZ 85251

Michael Grant
GALLAGHER & KENNEDY
2600 N. Central Avenue
Phoenix, AZ 85004

Suzanne Dallimore
ATTORNEY GENERAL'S OFFICE
1275 W. Washington Street
Phoenix, AZ 85007

Lex Smith
BROWN & BAIN, P.C.
2901 N. Central Avenue
Phoenix, AZ 85001-0400

Michael Patten
BROWN & BAIN, P.C.
2901 N. Central Avenue
Phoenix, AZ 85001-0400

For Parties of Record in Docket No. U-0000-94-165

Vinnie Hunt
TUCSON DEPT. OF OPERATIONS
4004 South Park Ave., Bldg. 2
Tucson, AZ 85714

William Sullivan
MARTINEZ & CURTIS, P.C.
2716 North Seventh Street
Phoenix, AZ 85006

Elizabeth S. Firkins
INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS L.U. #1116
750 South Tucson Blvd.
Tucson, AZ 85716

Paul Bullis
Chief Counsel, Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

Jerry Rudibaugh
Chief Hearing Officer
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

Andrew W. Bettwy
Assistant General Counsel
SOUTHWEST GAS CORPORATION
5241 Spring Mountain Road
Las Vegas, NV 89102

Debra Jacobson
Manager, State Regulatory Affairs
SOUTHWEST GAS CORPORATION
5241 Spring Mountain Road
Las Vegas, NV 89102

For Parties of Record in Docket No. U-0000-94-165

Roderick G. McDougall
City Attorney
200 W. Washington St., Suite 1400
Phoenix, AZ 85003-1611

William J. Murphy
200 W. Washington St., Suite 1400
Phoenix, AZ 85003-1611

Larry K. Udall
2712 N. Seventh Street
Phoenix, AZ 85006-1090

Russell E. Jones
33 N. Stone Ave., Suite 2100
P.O. Box 2268
Tucson, AZ 85702

Christopher Hitchcock
P.O. Box 87
Bisbee, AZ 85603-0087

BARRY, HETZER, STICKLEY & SCHUTZMAN
Court Reporters
2627 N. Third Street, Suite 3
Phoenix, AZ 85004-1103

Albert Sterman
ARIZONA CONSUMERS COUNCIL
2849 East 8th Street
Tucson, AZ 85716

98-04/ASBA Jan 21 cover letter.doc//1-16-98

BEFORE THE

ARIZONA CORPORATION COMMISSION

DOCKET NO. U-0000-94-165

TESTIMONY OF TOM BRODERICK

On Behalf of

THE ARIZONA SCHOOL BOARDS ASSOCIATION, INC.

January 21, 1998

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TESTIMONY OF TOM BRODERICK

(Docket No. U-0000-94-165)

I. INTRODUCTION AND SUMMARY

Q. Please state your name, address, professional background and experience, and whom you are representing.

A. My name is Tom Broderick, 6900 East Camelback Road, Suite 800, Scottsdale, Arizona 85251. I am a contract Regulatory Consultant for PG&E Energy Services Corporation ("Energy Services") and am presenting testimony on behalf of the Arizona School Boards Association, Inc. ("ASBA") in this proceeding. My background and experience appear in Attachment TB-1.

Q. Please briefly describe the Arizona School Boards Association and its members.

A. ASBA is a nonprofit corporation, the members of which are the governing boards of more than 210 of Arizona's 225 public school districts. Approximately 725,000 students attend ASBA member schools. The ASBA was formed in 1949 to advance and protect the interests of Arizona's public schools in public forums. Public school districts are major consumers of electricity in the state.

Q. Please explain why a representative of Energy Services, a prospective new entrant electric services provider in Arizona, is presenting testimony on behalf of an entity such as ASBA in this stranded cost proceeding?

A. Expert testimony in regulatory proceedings is but one of a number of unregulated value added energy-related services Energy Services provides to customers. Energy Services recently acquired the consulting firm of Barakat & Chamberlin and, as a result, possesses significant regulatory consulting resources.

Q. Please summarize your testimony.

A. The purpose of my testimony is two-fold. First, to present for the Commission's consideration a proposal under which Arizona's public schools would receive a variance or exemption from stranded cost recovery responsibility. This proposal is based on public interest considerations. Second, in response to the procedural orders previously issued in this proceeding, I will offer comment upon certain aspects of Issues 6 and 1 identified in those orders.

Q. Please describe ASBA's proposal for a variance or exemption.

A. The Arizona schools have a strong and compelling public interest in paying little or no stranded cost in connection with the transition to a competitive electric industry in the state. Arizona school funding currently ranks 45th in the nation and is in a

state of crisis. This crisis extends to both funding of capital requirements and keeping pace with inflation in maintenance and operation expenses. Any reduction in electric bills would significantly lower the cost of educating K–12 students in Arizona and, thus, make funds available for educational purposes and / or lessen the education-related burden otherwise borne by Arizona taxpayers.

Through its appearance in this proceeding, ASBA is requesting that the Commission expressly grant an exemption for Arizona public schools from any stranded costs which may ultimately be determined by the Commission to exist as a consequence of implementation of its electric competition rules. Such exemption should also include exemption from any early stranded cost recovery that occurs from the date an exemption is granted until the date when schools have choice of supplier. ASBA believes the predicate to such a public interest exemption already exists within the general context of the electric competition rules and the specific language of R14-2-1615 (C) of the rules. That Section provides for Commission consideration of "variations or exemptions from the terms or requirements of any of the rules…[when] the public interest will be served by the variation or exemption…"

ASBA believes that the creation of a variance or exemption for Arizona public schools from any responsibility for payment of stranded costs would be consistent with the public interests of the State of Arizona and its residents and taxpayers.

ASBA welcomes the opportunity to provide additional information to the Commission if that would be helpful to its decision-making.

II. ISSUE 6 (WHO SHOULD NOT PAY STRANDED COSTS)

Q. Should ASBA's members pay stranded costs?

A. No.

Q. Why not?

A. As previously indicated, electric rate reduction resulting from an exemption from stranded costs would significantly benefit the students who attend public schools and / or Arizona taxpayers.

Q. Please describe the fact situation for Arizona's public schools and discuss the public interest arguments in their favor:

A. The situation is:

1. Arizona schools funding ranks 45th lowest among the nation's 50 states. This unfortunate state of affairs is due, in part, to the fact that funding for the maintenance and operations of schools has failed to keep pace with inflation

for nine of the past ten years. The Legislature also is currently under a judicial mandate to devise a more equitable system of funding capital facilities and equipment. Clearly, obtaining additional revenues for public schools in Arizona will be extremely difficult and, thus, achieving all possible cost reductions is imperative.

2. Electric rate reductions could beneficially factor into an overall solution to improvement of Arizona school funding.

3. Schools in low property wealth districts and schools with older facilities are likely to be the least efficient consumers of electricity today and stand to benefit the most from electricity price reduction by virtue of their corresponding greater electricity consumption.

4. A number of parties have proposed that stranded cost recovery be in proportion to current rate design. Yet, some schools may have little or no operations during Arizona's hot summer months and some may not have air conditioning, yet the design of their current utility tariffs does not fully consider the benefits of such off-peak consumption.

5. Ultimately, if Arizona's schools pay any stranded costs, they generally will be paid from money that could otherwise go into classrooms and / or passed on to Arizona's residences and business through taxes higher than otherwise to fund schools. In the latter instance, it makes no sense to impose the public schools' allocation of stranded costs on residences and businesses that are **already** being asked by the utilities to pay stranded costs on their **own** homes and business facilities. It is simpler to exempt the schools.

6. At least one utility, APS, believes there will be significant loss of tax revenues in Arizona as a result of electricity competition. The highly publicized and so called "Pollock" study predicts a $1 billion loss in state and local taxes. The study also discusses the potential for shutdown of power plants in Arizona:

> Based on what has happened in other industries that have been deregulated, and based on what has happened to generation capacity in the United Kingdom, it would not be unusual to see uneconomic assets, in terms of generation capacity, being closed down. Plants at risk are those with high variable, but potentially avoidable costs, in such areas as fuel expenses, payroll and property taxes that exceed current market prices, such as coal plants facilities. The APS Cholla plant in Joseph City, Arizona, Tucson Electric Power's Springerville plant and Salt River Project's Coronado facility could someday fall into this category. (Pollock testimony, page 18.)

> For example, the plant (Cholla) represents 97% of the full cash value in the Joseph City School District and 96% of the Joseph City School District's funding comes from local property taxes. (Pollock, page 20.)

APS's CEO Mr. William Post cited the study in a February 28, 1997, letter to the Arizona Legislature and then Governor Symington.

Therefore, APS has endorsed a study that predicts devastating revenue loss or significant tax shifts for some Arizona schools and has also requested that those same schools pay stranded costs. If the envisioned impact of deregulation on school finance is likely to occur, then clearly it is appropriate to exempt schools from stranded cost recovery.

Q. How should the utilities recover any shortfall resulting from exempting the Arizona schools?

A. This is a policy call for the Commission. The ASBA is of the opinion that any shortfall should **not** be recovered from other utility customers, but left for the utility to mitigate or absorb. The ASBA's opinion is based, in part, on the tremendous tax relief utilities have received in recent years.

The shortfall created by a schools exemption is likely a small amount relative to total utility revenues. I estimate the Arizona K–12 grades contribute no more than 1 to 2 percent of statewide electric utility revenues. The affected utilities could easily confirm this statistic. Assuming stranded costs are 10% of total utility costs, then stranded costs attributable to Arizona's schools are **no more than** 0.1% to 0.2% of statewide electric utility revenues. Thus, while being relieved of these costs will be very important to schools, the reduced revenue will be of little consequence to the utilities.

III. ISSUE 1 (RULES CHANGES)

Q. Are changes to the Commission's electricity restructuring rules necessary in order for the schools to prevail?

A. No. In fact, the basis for ASBA's request has its origins in the electricity restructuring rules themselves. Section R14-2-1615 (C) of the Commission's December 26, 1996, electricity restructuring rules states:

> The Commission may consider variations or exemptions from the terms or requirements of any of the rules in this Article upon the application of an affected party. The application must set forth the reasons why **the public interest** *(emphasis added)* will be served by the variation or exemption from the Commission rules and regulations.

Hence, under the current rules the schools could file an application for an exemption from Section R14-2-1607 (Recovery of Stranded Cost) and set forth the reasons for why the public interest is served by a Commission approved exemption from stranded costs. And, although it would additionally make sense for the Arizona schools to be eligible for direct access no later than January 1, 1999, in order to obtain competitively priced electricity, this is not absolutely necessary for the schools to be granted an exemption from stranded costs.

Q. Are you suggesting that the Commission established a new avenue for obtaining rate concessions from affected utilities in their December 26, 1996, electricity restructuring rules?

A. In essence, yes. For a number of years, the Commission has approved rate reductions from tariffs or special contracts for customers that successfully demonstrated a viable competitive alternative. For example, the threat of customer self-generation has led to reduced electric prices.

As the ASBA and I read the Commission's electricity competition rules, it appears the Commission has established a similar exemption for customers successfully demonstrating the public interest will be served through a granting of an exemption.

Q. Has any entity to-date applied for an exemption under Section R14-2-1615 (C)?

A. Not that we are aware of. Thus, the schools could be a test case for this new standard.

Q. Do you believe the Arizona public schools should be granted an exemption from paying stranded costs?

A. Yes. I believe granting the Arizona public schools such an exemption is strongly in the public interest. The ASBA requests the Commission grant, in their Order in this proceeding, an exemption from paying stranded costs for the Arizona public schools to further the public interest. The ASBA requests the exemption be made effective upon the date of the Order so as to also exempt the public schools from

any early stranded cost recovery programs. APS's regulatory asset recovery program is an example of such an early recovery program.

Q. Does Energy Services support stranded cost recovery by the Affected Utilities?

A. Yes. As Douglas A. Oglesby testified, Energy Services supports a reasonable opportunity for Affected Utilities to recover stranded costs but only if they voluntarily sell generation assets. However, we note that the Commission has created exemptions from stranded costs for self-generation and demand-side management. ASBA has asked Energy Services to assist it in demonstrating to the Commission that the public interest also warrants an exemption from stranded costs for Arizona's public schools, and we are pleased to be able to provide our expertise on their behalf to obtain lower electricity costs.

Q. Does this conclude your testimony?

A. Yes.

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Attachment TB-1

Professional Background and Experience of Tom Broderick

Mr. Broderick has 14 years of experience in regulatory and economic issues in the electric industry. Currently, he is a Regulatory Consultant for PG&E Energy Services. His responsibilities include electric de-regulatory advocacy and analysis in Arizona, New Mexico, Utah and Nevada. He has recently testified in the Arizona, New Mexico and Utah legislatures on electricity deregulation. He has been an active participant in the Arizona Commission's recent work groups on electricity restructuring.

Prior to consulting for PG&E Energy Services, he was employed by Arizona Public Service Company from 1984-1996. At APS, Mr. Broderick served as Regulatory Economist, then Regulatory Affairs Supervisor, then Forecasts Department Supervisor and Chief Economist, then Planning Manager. In these various capacities, he prepared testimony for APS personnel or for himself in numerous rate cases, prudence audits, and integrated resource plan hearings. Mr. Broderick was responsible for preparation of APS's load forecasts for many years. Beginning in 1994, Mr. Broderick was responsible for analysis and strategy recommendation in preparation for electric deregulation.

Prior to joining APS, Mr. Broderick was a Marketing Research Analyst for Miller Brewing Company, Milwaukee, Wisconsin. Before that, he was an Economist for an Illinois state agency that regulated hospitals.

Mr. Broderick holds a Master of Science from the University of Wisconsin - Madison and a Bachelor of Science from Arizona State University.

BEFORE THE

ARIZONA CORPORATION COMMISSION

DOCKET NO. U-0000-94-165

TESTIMONY OF DOUGLAS A. OGLESBY

Vice President and General Counsel

On Behalf of

PG&E ENERGY SERVICES CORPORATION

January 21, 1998

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TESTIMONY OF DOUGLAS A. OGLESBY

(Docket No. U-0000-94-165)

I. INTRODUCTION

Q. Please state your name, address, professional background and experience, and whom you are representing?

A. My name is Douglas A. Oglesby, 345 California Street, Suite 3200, San Francisco, California. I am Vice President and General Counsel for PG&E Energy Services Corporation ("Energy Services") and am representing it in the proceeding. My background and experience are set forth in Attachment DAO-1.

Q. Do you have previous experience relative to restructuring of the electric utility industry and to proposals relating to the recovery of "stranded costs"?

A. Yes. I have been actively involved for many years in a wide range of electric industry restructuring activities at both the Federal and state levels, including extensive participation in the California restructuring proceedings. Much of this activity has involved stranded cost issues. This activity includes my advocacy of stranded costs policies before legislative committees of two states and before the Federal Energy Regulatory Commission, on behalf of the Edison Electric Institute,

the trade association for investor-owned utilities. I am quite familiar with stranded cost recovery policies, and in particular am very familiar with California's stranded cost provisions and processes to date. I also am familiar with the stranded costs implications of several recent sales of generation assets by utilities, in particular the recent sale by the New England Electric System ("NEES") of its non-nuclear generation assets to Energy Services' affiliate US Generating Company ("US Gen"), and the sale by Energy Services' utility affiliate Pacific Gas and Electric Company ("PG&E") of several large fossil generation plants. I am also either personally active in or direct the efforts of Energy Services staff on electric restructuring analysis and advocacy in many states having high commercial priority for Energy Services, including Arizona, Oregon, New Mexico, Utah, Nevada, Washington, Illinois, Texas, and Pennsylvania.

Q. Please summarize your testimony.

A. This testimony advances a proposal for stranded costs determination and recovery for the Arizona utilities which is both fair to Arizona electric customers and to the utilities and their shareholders, and which will encourage the development of competitive electric markets. This proposal is predicated on the divestiture of the generation assets of the Arizona utilities. Recent utility generation asset sales have resulted in sale prices well in excess of the depreciated book value of the assets. These sales have therefore not only established a market valuation for the assets'

value, but have also permitted the utilities to credit to their ratepayers the premium over book, enabling them to "buy down" their stranded costs. In all cases of which I am aware, the sale proceeds exceeded the utilities' expected revenues.

A stranded costs valuation and recovery program must (1) afford the utilities a reasonable opportunity to recover all legitimate, verifiable and non-mitigatable stranded costs in a (2) competitively neutral manner over (3) a relatively short transition period. These three criteria are essential in order to encourage a competitive market in electricity to develop and to enable Arizona consumers to achieve substantial reductions in the delivered cost of electricity as soon as reasonably practicable. Our proposal satisfies these three criteria. It is premised on the Arizona utilities' voluntary divestiture of their generation assets, both nuclear and non-nuclear. Sales of non-nuclear generation are very likely to result in sale prices well in excess of the assets' depreciated book value. Therefore, if a utility elects to keep its generation on a regulated basis rather than to sell it, that asset's market value would be deemed to be its depreciated book value, resulting in no stranded cost attributable to the retained generation. Sale proceeds in excess of book would be credited against other potential stranded costs, such as regulatory assets and nuclear decommissioning costs.

Nuclear assets would be treated somewhat differently because of the greater uncertainty that their offer for sale would generate above-book bids. If no viable bid

is made, or if the highest bid is nonetheless below book, the difference between market and book value would be the nuclear component of stranded costs.

All stranded costs would be recovered through a non-bypassable Competition Transition Charge (CTC) over a period of four years. At the end of this four-year period, the CTC would be eliminated, and all cost recovery by the utilities would be on a market basis.

Each utility would develop for Commission review and approval a standard offer tariff for the provision of delivery and supply services to their customers who are not eligible for or do not choose an alternative supplier during the phase-in period before all customers are eligible for direct access. This tariff would include charges for regulated transmission, distribution, public benefits charges, the CTC, and energy. The price for the energy component of this standard offer tariff would be the market cost of the utility's power purchased to meet this supply obligation. The difference between this purchased power cost and the Commission-approved nuclear revenue requirement on a kilowatt-hour basis would be the nuclear component of the CTC. In effect, then, this difference is the difference between market value and book value of the nuclear investment.

II. GENERAL CONSIDERATIONS AND A PROPOSED SOLUTION

Q. Who is Energy Services and what are the nature of its business activities?

A. Energy Services is an unregulated subsidiary of the diversified energy holding company, PG&E Corporation, headquartered in San Francisco. Energy Services sells gas and electric commodities and a wide range of other energy-related products and services nationwide, including Arizona, where it has had an active sales office for about two years. Energy Services' activities are **not** regulated by the California Public Utilities Commission ("CPUC") or any other state commission, and it is structurally, organizationally, functionally, operationally, and financially fully separate from its utility affiliate Pacific Gas & Electric Company ("PG&E").

Q. Has Energy Services previously participated in proceedings before the Commission involving restructuring of the electric utility industry in Arizona?

A. Yes. Energy Services has actively participated in this Commission's retail competition proceedings since it issued its proposed rules in mid-1996, and has attended and submitted comments in several of the Commission-established working groups, including the three subcommittees on stranded costs.

Q. Has Energy Services also been active as a party in the litigation in Maricopa County Superior Court involving the Commission's Decision No. 59943 and the Electric Competition Rules?

A. Yes. In that case we have actively supported this Commission's authority to issue its retail competition rules and to restructure the Arizona electric industry.

Q. Why is PG&E Energy Services interested in the outcome of stranded cost issues in Arizona?

A. Arizona is an important market for Energy Services. Energy Services has very ambitious business objectives and Arizona's attractive customer markets, and its close geographic proximity to California make Arizona a very attractive location for us to do business.

However, the methods adopted by this Commission for stranded cost calculation and recovery and related incentives will dramatically impact the ability of my company to compete successfully in Arizona. Throughout 1997, we have repeatedly advocated in Arizona regulatory and legislative forums four basic themes regarding stranded cost recovery: First, as a condition to being permitted the opportunity to recover stranded costs, an Affected Utility must enable those customers eligible for direct access the opportunity to purchase competitive electric

supply at prices lower than those of the Affected Utilities. Second, stranded cost recovery must be a competitively beneficial or , at a minimum, a **neutral** factor in an eligible customer's decision to select an alternative competitive supplier or remain on "standard offer" tariffs. Third, Affected Utilities must not have the opportunity to recover more than 100% of stranded costs, but neither should they be arbitrarily limited to recovery of some lesser percentage of legitimate, verifiable and non-mitigable stranded costs. The utilities should be provided a reasonable opportunity to recover their stranded costs over a limited transition period of 3-5 years by way of a non-bypassable competition transition charge ("CTC"). CTC exemptions should be limited to those the Commission has already adopted for self-generation and demand-side management and those that qualify for an exemption under the Commission's rule permitting exceptions based on the public interest.

We offer here a proposal which satisfies each of these criteria.

Q. Please describe your proposal and discuss the reasons why Energy Services believes it is responsive to the indicated criteria.

A. An essential premise of our proposal is this Commission's continued steadfast commitment to permitting Arizonans to choose their electricity supplier. To summarize, under our proposal a utility would be permitted an opportunity to recover its generation-related stranded costs during the transition period only if it

divests its generation assets (including a good faith effort to sell its nuclear generation). More specifically, our proposal calls for:

1. All non-nuclear generation would be sold (to private entities only, or, if publicly owned, through use of non-tax exempt debt) through a Commission supervised auction. If a utility chooses not to sell all its generation by a specified date, the generation's market value would be presumed to be its depreciated book value and, therefore, not to have any stranded costs. If for any reason beyond the utility's reasonable control, a sale cannot take place, then the generation would be valued on the basis of the highest bid (if at least three bids) or through an independent appraisal.
2. Proceeds from generation asset sales in **excess** of embedded balance sheet cost will be applied to recovery of approved nuclear and non-generation-related stranded costs, such as prudently incurred nuclear decommissioning, regulatory assets, and one-time generation employee severance costs (union and clerical only). Any remaining nuclear and non-generation-related stranded costs would be subject to the prospect of recovery during the transition period through the nonbypassable CTC. While the Commission has authority to approve accelerated recovery of decommissioning and regulatory assets, such acceleration is not necessary under this proposal, especially if reductions in standard offer prices are sought. Recovery of these remaining costs occurs largely through cost of service assignment to distribution even

with recovery over normal amortization schedules. No other costs of service would be eligible for stranded cost recovery. In the unlikely event that the sale proceeds fail to recover the depreciated book value of the assets, the utility would be permitted to recover the shortfall through the non-bypassable CTC.

3. As previously mentioned, nuclear generation must also be offered for sale. However, in the event that such an offer does not result in any viable bids, recovery of the above-market investment will be permitted in the CTC. During the transition period, the nuclear component of CTC's would be calculated as the difference between the standard offer price of electricity and the net book value calculated on a per kilowatt/hour basis. If the nuclear asset is sold, but at a price that does not fully recover depreciated book, the unrecovered amount of the investment would be accorded stranded cost recovery calculated as described above. Revenues from the sale in excess of depreciated book would be treated the same as excess revenues from the sale of non-nuclear generation. Duke Energy has just announced its interest in the nuclear units of Ontario Hydro, so I would expect that an offer of the Arizona utilities' interests in nuclear units would result in viable bids.

It is certainly possible that the nuclear utilities may not be able to recover 100% of their stranded costs during the transition period, due to the magnitude of their nuclear investment. It is also quite possible they will be able to do so.

In any event, the utilities will be permitted to recover as much of their approved stranded costs as they can during the transition period. The California investor owned utilities were faced with much the same prospect, and they responded by restructuring their nuclear assets through such techniques as accelerated depreciation and, in the case of Diablo Canyon, PG&E's nuclear plant, foregoing authorized price increases in that plant's performance-based settlement agreement. The result was that PG&E is voluntarily foregoing billions of dollars on a net present value basis of its nuclear generation profits. Arizona utilities should be expected to do likewise in order to provide a fair opportunity for Arizonans to enjoy the benefits of competition and to be permitted to recover the great bulk, if not 100%, of their non-nuclear stranded costs without the operating risk to which they would otherwise be exposed under a traditional regulatory regime which requires that the assets must be used and useful to warrant recovery of their costs in base rates.

4. As a method of increasing bids for power plants, the Commission could establish non-bypassable property tax adjustment clauses for actual property taxes due on the (presently) Arizona utilities' owned portions of Palo Verde, Coronado, Springerville and Cholla power plants. The property tax clauses would collect actual property taxes due (subject to capping at present dollar amounts) from each utility's existing retail customers in regulated distribution charges for the remaining life of each identified plant based on applicable

state tax law regardless of who is the owner. Future capital additions would be excluded from recovery in these clauses. Thus, the new plant owners would not be burdened by Arizona's property taxes and bids would accordingly be much higher. As a result, proceeds to Arizona's utilities from asset sales would be greater and their remaining stranded costs much lower. Such clauses will not only improve the competitiveness of each of these plants but also address alleged rural Arizona property tax losses resulting from electricity competition.

5. The financial responsibility for nuclear decommissioning would remain with the existing customers of nuclear utilities. This should result in higher bids for nuclear assets.

Q. In item 3 above, did you indirectly say that under a net revenues lost method PG&E did not receive 100% stranded cost recovery?

A. Yes. PG&E has an opportunity to recovery nearly 100% of its stranded costs based on market methods, but this is much less than 100% based on a net lost revenue method. This is a direct result of the reductions PG&E made in the prices authorized in its Diablo Canyon performance-based agreement, the CPUC's reducing the allowed return on generation equity to 90% of the embedded cost of debt to reflect reduced risk associated with stranded cost recovery, and the relatively short 4-year recovery period, which puts the utility at substantial market risk that

stranded costs might not be fully recovered prior to expiration of the transition period.

Q. How would your recommendation impact the state's major regulated utilities?

A. TEP has no nuclear, and therefore no nuclear decommissioning costs, and I am informed relatively low regulatory assets. Hence, it would retain its surpluses from asset sales and, thus, stands to do relatively well under this proposal. APS would be allowed to continue to collect its substantial regulatory assets, although not necessarily on an accelerated basis, and its nuclear decommissioning costs and could receive tax clauses on both Palo Verde and Cholla power plants with the resulting economic benefits previously mentioned.

As a result of property tax clauses on recent vintage power plants and the relief from nuclear decommissioning financial responsibilities, Arizona's utilities that believe they have stranded costs will have strong incentives to sell under a timely deadline.

In summary, with the exception of nuclear, if a utility is not willing to voluntarily sell its generation assets within established deadlines, then it would receive no additional stranded cost recovery and no property tax clause. This program could begin immediately and be largely completed in 1998, although nuclear sales may

take somewhat longer. The major impact of asset sales on unbundled tariffs could be determined in late 1998, just prior to the start of competition. Hence, the basic design of unbundled tariffs can continue on a separate parallel course.

Q. Why does Energy Services strongly prefer an asset sale over other market based methods?

A. It is by far the fairest method to recover stranded costs from Arizona retail customers and yet allow for stranded cost recovery. Retail customers pay stranded costs (decommissioning, regulatory assets, and severance) only after the utility applies the proceeds from the highest bid to its stranded costs. Other methods, which rely on forecasts or assumptions of market price are based on averages. I don't know of anyone that would sell a home, car or business based on an average of offers they receive. Rather, people sell to the highest bidder. This creates the most value. Everyone's expectation of future price is always different. Why would the Commission want to use an average expectation and risk making retail customers pay more than what's actually stranded?

Q. In the case of the NEES sale, some losing bidders are saying that US Gen paid too much. Are NEES' retail customers saying that?

A. No. NEES's customers should be delighted with the sale, since the price US Gen paid was about 140% of the depreciated book value of the assets sold. NEES's retail customers will pay less in stranded cost as a result. The market price for electricity is independent of NEES's sale price.

Q. What do you mean by "creating" market value?

A. In New England, for instance, the winning bid exceeded expectations. This occurred, in part, because the US Gen's winning bid included an incentive payment of $225 million to NEES if they open their markets to retail competition no later than January 1, 1999. Payments decline substantially for dates thereafter. It is only through asset sales that value can be created.

It is apparent to outside observers that Palo Verde nuclear station is Arizona's primary stranded cost problem. Regulatory assets and decommissioning are largely nuclear related. Property taxes are also significant for nuclear plants. Energy Services' proposal specifically allows recovery for identifiable components of nuclear costs and creates an opportunity for Arizona's utilities to sell their nuclear generation assets at prices above net book values.

Q. Do existing stranded cost recovery programs in Arizona cause you concern?

A. Yes. APS, for example, in its Rate Reduction Agreement, is currently recovering $110 million annually in stranded costs relating to regulatory assets prior to the onset of retail competition. Yet this Rate Reduction program neither requires APS to undertake any real steps to prepare for competition nor even to provide genuine assurances of that eventuality. Rather, APS now has strong incentives to delay the onset of competition in Arizona and, in our opinion, that is exactly what it and the state's other major utilities are doing.

Q. Do you think that the Arizona utilities will cooperate to foster retail competition if the Commission first allows them to recover their stranded costs?

A. No. The existence of stranded costs is a double edged sword. On the one hand, recovery is a major issue to solve. On the other hand, recovery can provide incentives to cooperate. Several utilities across the nation with little or no stranded costs are stalling competition in their own territories. Take Utah for example. PacifiCorp's unit Utah Power and Light is stalling competition in that state despite having generation costs of only 2.5 cents per kilowatt hour. Utah is thus struggling with finding the means to motivate PacifiCorp to cooperate. PacifiCorp has also sought to avoid application of the California restructuring orders to its California

customers. PacifiCorp, however, is actively participating in advancing Nevada's restructuring process. We see this time and again: In fact, TEP's chairman Charles Bayless is a staunch advocate of retail competition outside Arizona, but resists it mightily in his backyard. APS is actively marketing at retail in California, having opened an office in the Los Angeles area and successfully obtaining electric service provider status in the Sacramento Municipal Utility District's retail program. There is a very real effort by many utilities, including Arizona's, to stall competition on the home front while aggressively seeking to advance and reap its benefits elsewhere.

In California, there is a tremendous momentum behind competition despite the delay in direct access from January 1, 1998, to March 31, 1998. Considering all that has occurred in California the past 18 months, it is remarkable that the California ISO / PX will only miss the start date by 3 months. Despite the delays caused by the unnecessarily complex ISO/PX systems, the fact that California is continuing to move forward on retail competition with the cooperation of the state's major utilities can only be attributed in large part to California's explicit linking of stranded cost recovery to the timely onset of competition and asset sales. Many other aspects of California's restructuring are on schedule including fossil asset divestiture and residential rate reductions (10%). Our asset sale proposal assures Arizona there will be competition following stranded cost recovery.

III. ISSUES OF PARTICULAR IMPORTANCE TO ENERGY SERVICES OR THE ARIZONA SCHOOL BOARDS ASSOCIATION

Q. Which of the issues identified in the Initial Procedural Order are most important to Energy Services?

A. All of the issues are important, but Issues 3 (calculation method), 8 (price caps), 9 (mitigation), and their impact on 1 (rules) in that order are the most important to us.

Q. With regard to Issue #3, what costs should be included as part of "stranded costs"?

A. Only legitimate, verifiable and non-mitigatable costs imposed by the onset of competition should be eligible for the prospect of stranded cost recovery. For instance, unamortized regulatory assets and nuclear decommissioning costs would be eligible for recovery but only under an asset sale scenario. As previously discussed, property taxes could likewise have an adjustment clause in order to increase bids and further the public interest.

However, an avoidable cost that is simply unaffordable at competitive prices should not be allowed recovery. For instance, marketing and sales expenses, corporate overheads and all other avoidable or semi-avoidable costs allocated to competitive

services should not be allowed recovery as stranded costs. Competitive services in this case also includes the standard offer sale of energy. This is because it is the energy component of the standard offer tariff that will be the competitive product. Energy service providers, such as Energy Services, will have to compete with the standard offer energy price in order to market successfully in Arizona. Some one-time employee severance costs may be an appropriate exception, depending on the circumstances. California's legislation permitted recovery as stranded cost only severances for union and clerical employees. The job market for professionals is very strong today.

In addition, the Commission must be sure to include all prior amounts of stranded cost recovered by the affected utilities in their determination of the total amount of recoverable stranded costs. In this regard, APS' accelerated recovery of regulatory must be accounted for in determining the total amount of stranded costs APS will be permitted to endeavor to recover during the transition period.

Q. With further reference to Issue #3, how should those costs be calculated?

A. Net revenues lost methods should not be used. Net revenues lost is an arbitrary method which inevitably leads to a reduction in incentive to mitigate and a reliance on assumptions and computer models, not market realities. Periodic true-ups do not solve the problems inherent in a net revenues lost method. A revenue lost approach

also carries a very high risk that costs will be recovered which should not be accorded stranded cost treatment, such as marketing and sales costs.

Net revenues lost can also mislead customers about eventual rate decreases upon expiration of stranded cost recovery. In other words, a subsequent increase in regulated distribution rates can lead to less of a rate reduction upon expiration of stranded cost recovery. A utility can make such an increase in distribution rates more palatable (hidden) under a net lost revenues recovery mechanism because the increase will have the appearance of stranded costs.

Q. What approach does Energy Services recommend?

A. As previously discussed, we recommend the Commission use asset valuation as the method for determining the amount of stranded costs eligible for recovery. Specifically a method based on the highest bid for generation offered for sale. We also believe that the utilities should not be permitted to include as recoverable stranded costs any above-market costs incurred after December 26, 1996, the effective date of Decision 59943. Certainly with the issuance of the retail competition rules on that date, the utilities were then on notice that any new investment must survive a market test. For previously stated reasons, voluntary asset sales are emerging in the U.S. as the preferred calculation method. Proceeds from sales can credit existing debt and common equity in their current capital

structure percentages, unless the Commission wants to modify existing financial leverage. Retail customers only pay stranded costs remaining after netting surpluses from proceeds in excess of embedded balance sheet amounts.

Arizona has no PURPA contracts and fortunately does not face above market purchased power contracts, which is a large component of stranded costs in California. Under our "solution," purchased power contracts should be included for sale in the "all other" generation category.

Q. With reference to Issue #8, should there be price caps or a rate freeze imposed as part of the development of a stranded cost recovery program; and, if so, how should they be calculated?

A. The Commission should establish a price ceiling in the form of standard offer tariffs. Standard offer tariffs should be available to all retail customers. Such standard offer tariffs should be predicated on voluntary generation asset sales and thus would recover only essential distribution, transmission, the CTC (which recovers Commission-authorized stranded costs comprised of regulatory assets, nuclear investment and decommissioning costs, property tax adjustment clause(s), sales taxes, and regulatory assets), and other system benefits charges only after crediting surplus proceeds from asset sales. Of course, standard offer must include a generation component.

Q. How would the generation component price be established?

A. After generation sales, all generation (with the exception of nuclear if not sold) will have been marked to market. If not sold, the nuclear plants should be deemed to be dispatched first. Since nuclear will be insufficient to meet the nuclear utilities' standard offer loads, they will be required to make up the difference with purchased power. The (market-based) purchased power will be deemed the standard offer generation price (with appropriate load factor adjustments). During the four year transition period, the difference on a kilowatt per hour basis between the market purchased power cost and the nuclear revenue requirement will be the nuclear component of the CTC. The incumbent utilities can then offer market based (purchased power) generation prices in standard offer. Purchases will, for a while, largely come from market priced purchases from the new owners of recently sold power plants. We recommend the Commission prohibit a utility from constructing or owning power plants on a regulated basis following voluntary asset sales. Such a ban, of course, would not apply to any unregulated and separate affiliates of the utility.

We observe that nuclear may very well be quite competitive under Energy Services proposal. The purchaser of the nuclear interests of the affected utilities will not be burdened with the costs of regulatory assets, nuclear decommissioning or property

taxes. Nuclear, will, however, in all other regards be exposed to market forces. Inefficient management of Palo Verde could (and should) result in poor financial performance for its new owners. We also note that if the nuclear assets do not sell, with only a 4 year period to recover their stranded costs, the utilities will have ample incentive also to manage their nuclear assets efficiently.

Q. What else should be considered in connection with use of the standard offer as a price ceiling?

A. Clearly, an important consideration under this approach is the quality of the unbundled tariffs for Arizona's affected utilities. A mis-assignment of competitive (generation) costs to regulated services will reduce competition because the generation component of the standard offer will be too low and stifle competition. For example, certain costs, such as sales, customer service and marketing, should be assigned to the generation function because a competing electric service provider must recover those costs in its commodity price, and does not have the option of loading those costs on to other, regulated functions (such as transmission and distribution) because it does not have such functions. In other words, the only way new entrants such as Energy Services can beat a standard offer price is if that price reflects the true costs to the utility to provide that service in the competitive market.

We do not have a strong preference for how metering and billing costs are treated under standard offer, except that they should be fair and properly assigned to the appropriate function. While a complete exit from the merchant function by the utility is inevitable, these services could be included in standard offer for some period of time under our proposal.

In Energy Services' opinion, our solution offers a real opportunity for Arizona. The California option of establishing an overall rate freeze and crediting back on customers' bills the power exchange price, metering and billing is not available (nor really desirable) in Arizona. First, Arizona has not established a power exchange. Second, the commitment behind Desert Star is still not 100%, plus Arizona has a vision of a less complicated market structure. Indeed, the California structure is unnecessarily complex and is not essential to the creation of a true competitive market. It should not be replicated in Arizona.

It is likely the Arizona utilities would want a set expiration date for standard offer under this proposal. This is because standard offer is a fixed price offering and the utilities will want to align their resource purchases to an established time frame. Eventually, standard offer must expire. Once all retail customers are eligible for retail access, standard offer can phase out and be replaced by competitive bidding for default service.

Q. With regard to Issue #9, what factors should be considered in the "mitigation" of stranded costs?

A. Ultimately, all stranded costs must be mitigated because electric rates should not be allowed to increase as a result of stranded cost recovery. Under Energy Services' proposal standard offer prices would likely decrease on January 1, 1999 (or earlier) because the proposal (i) uses the highest, not average, value of assets and captures surpluses to pay remaining stranded costs; (ii) does not require acceleration of stranded cost components to remain in good standing with the accounting community; and (iii) encourages mitigation through unbundling and direct competition inasmuch as no other regulatory crutches are provided to the utilities. An additional feature of our proposal is that the Commission needs to consider mitigation factors only in determining regulated tariffs. These factors are:

1. **Proper allocation of costs as between regulated competitive services**: Costs must be properly assigned and avoidable costs in competitive services must not be afforded stranded cost recovery. Rather, they should be funded by market revenues.
2. **Service territory economic growth**: Arizona is growing at a rate which consistently places it at or near the top of the 50 states year after year. Since there appears to be no support for excluding new customers from paying stranded costs, we suggest new growth is a very significant source for paying

stranded costs and / or for funding infrastructure required by competition (e.g., ISO). Because wholesale costs are much less than embedded revenues, new customers are contributing marginal revenues far in excess of marginal costs.

3. **The return on equity for generation assets**: Stranded cost recovery provides a level of assurance of recovery that exceeds that of traditional regulation. Generation equity returns, as a result, can be re-aligned with risk. Equity returns on regulatory assets eligible for stranded cost recovery should be reduced. In California, equity returns on all generation rate base were reduced to 90% of the level of the cost of debt for purposes of stranded cost recovery.

4. **The costs of competitive infrastructure**: These must be explicitly addressed or the utilities may claim that their revenues are inadequate to fund such infrastructure as an ISO, billing interface systems, and customer education. Although APS is presently collecting an additional $110 million in regulatory assets, it has publicly indicated it lacks funding for at least some programs. In other words, if not explicitly addressed, the utilities might claim every extra dollar goes for stranded cost recovery unless it suits their purposes (e.g., marketing efforts in California).

5. **Affiliate separation**: Complete separation between a utility's regulated, monopoly services and any competitive services is essential to the development of a competitive market. This separation requires that any competitive services must be offered, if at all, only through a separate,

unregulated affiliated entity (which must be a separate corporation). With proper accounting separation and transfer pricing rules, requiring that competitive activities be conducted through a separate entity, which permits more effective monitoring and oversight, the chances for cross subsidization of competitive services by regulated revenues are substantially reduced. Internal accounting controls are ineffective in ensuring that regulated services do not subsidize competitive services. Such subsidization will impose increased costs on ratepayers and damage competition. First, ratepayers would bear a portion of the utility's costs of providing the competitive service, and second, the ability of the utility to offer competitive services at lower prices (because a portion of its costs will be recovered in rates from ratepayers) will squelch competition from alternative providers who must recover all their costs of service in the prices of competitive services. It is simply impossible to police the utilities effectively to ensure there is no cross-subsidization of unregulated utility activities. For instance, the Arizona utilities keep insisting their California efforts are a result of this Commission's request to mitigate stranded costs. However, there is presently almost no profit potential in these efforts, only losses associated with starting up in new markets. We cannot help but wonder whether any margin the Arizona utilities are making on their California sales would be less than what would be eliminated from regulated rates if the total costs of their marketing efforts in California were known.

Q. With reference to Issue #1, Should the Electric Competition Rules be modified regarding stranded costs; and, if so, how?

A. Energy Services has no proposed modifications at this time. After reviewing the testimony and exhibits submitted in this proceeding, and considering the record as a whole, we may conclude some modifications are in order. In such event, we will communicate our views to the Commission and the parties.

IV. MISCELLANEOUS POINTS

Q. Do you have additional points to communicate?

A. Yes. I have some additional observations from Energy Services' experience in other states and comments about what has gone well in California.

Q. Is there anything of relevance in recent asset sales under California's mandatory voluntary fossil asset sale?

A. Yes. The California generation asset sales factor into "CTC" at their sales prices. Both Southern California Edison and PG&E have accepted very attractive bids for their fossil generation assets, Edison's at about 2.5 times book value, and PG&E's

at about a 1.3 multiple. In fact, at we know that at least one Arizona utility bid on at least one of PG&E's plants. Of course, there are fact differences between California, New England and Arizona, but the winning bids are so much higher than anyone contemplated a year ago in stranded cost discussions. I know of no reason why the result should be any different in Arizona.

Q. Does this conclude your testimony?

A. Yes.

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Attachment DAO-1

DOUGLAS A. OGLESBY
Vice President and General Counsel
PG&E Energy Services

Mr. Oglesby is responsible for all legal matters, including customer agreements, vendor contracts, energy transactions and regulatory representation. He is also responsible for energy policy issues, particularly legislative and regulatory policies concerning industry restructuring.

Mr. Oglesby has 20 years of legal experience in energy law and the utility industry. Mr. Oglesby came to PG&E Energy Services from a major international law firm where he was a partner in the firm's energy practice group. As a member of the firm, he represented large energy consumers, domestic and international independent power developers, power marketers and utilities on a wide range of energy issues.

Prior to private practice, Mr. Oglesby was an attorney in the law department of Pacific Gas and Electric Company, where for many years he served as Chief Counsel of PG&E's Electric Supply Business Unit. As Chief Counsel he was the principal legal advisor to the Business Unit's general manager and to PG&E's senior management on electric supply matters, and was responsible for all legal services required by the Business Unit, principally relating to electric resource planning, industry structure and restructuring, power plant fuel supply, bulk power, utility interchange, transmission and non-utility power transactions and associated pricing and rate issues.

Mr. Oglesby's practice has focused primarily on energy transactional matters, including power purchase contracts and transmission arrangements, and on issues related to electric industry restructuring. He has practiced extensively before the Federal Energy Regulatory Commission, the California Public Utilities Commission, the California Energy Commission, and other state and federal agencies on a wide range of energy-related issues, including utility rates. He has counseled extensively on transmission access and on removing barriers to transactions between energy consumers and suppliers. For the last several years he has been actively involved in industry structure legislative and regulatory policy issues including advocacy at both the state and federal levels on important energy services restructuring and competitive energy market issues. Among other accomplishments, Mr. Oglesby personally participated in the development of the 1992 National Energy Policy Act and helped shape that Act's provisions relating to independent power development and electric transmission. He has participated in numerous conferences and seminars as a speaker and panelist on energy policy issues.

Mr. Oglesby obtained his law degree from Boalt Hall School of Law, University of California, Berkeley and graduated from Oregon State University, Corvallis, Oregon, with a B.S. in General Science. He is also a graduate of the Harvard Business School Program for Management Development.